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The Impact of Slow Privatisation in the Beverage and Textile Industry in Eritrea

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Som-theme A Primary Processes within Firms
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Abstract

In many developing countries the privatisation of state owned enterprises is receiving increased attention but the selling of the enterprises is difficult. In Eritrea state owned enterprises were offered for sale at the end of 1996, but many of the relatively large companies are not privatised yet. This created the possibility to study the impact of slow privatisation in a developing country. After the privatisation announcement the state owned enterprises in both the profitable beverage industry as well as in the unprofitable textile industry showed negative effects on profitability. Moreover, managers in both industries complained about slow privatisation, but the complaints were different. In the profitable beverage industry privatisation frustrated the orientation on the future because the privatisation authorities restricted investments. The managers of the loss making textile industry were more involved with survival and they complained about the long duration of privatisation that made it impossible to get outside financing quickly.

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1. Introduction

The concept of privatisation can have various meanings [Starr, 1988], but if applied to developing countries the word "privatisation" generally implies a shift of ownership of companies from the state to the private sector. The intended shift of ownership stems from a multitude of reasons [United Nations, 1996; Megginson and Netter, 2000], but two major general economic reasons are the endeavour to create a more efficient economy as well as the need to alleviate governmental budgetary problems. Privatisation is therefore frequently propagated when bad economic conditions, high foreign debt, high dependence on international agencies and budget deficits prevail [Ariyo and Jerome, 1999; Ramamurti, 1992; Yarrow, 1999]. These economic circumstances may thus make privatisation urgent and some authors propagate a fast privatisation of state owned enterprises [Boyko, Shleifer and Vishny, 1996; Donaldson and Wagle, 1995; Bennell, 1997]. Other authors, however, propagate a gradual approach to privatisation, because the gain from hasty privatisation should be compared with the social costs of speed [Aghion and Blanchard, 1994; Katz and Owen, 1995] and because a speedy privatisation can result in poorly conceived privatisation schemes [Ramamurti, 1999].

In general, urgency is high in developing countries, and many of these countries started privatisation programs. However, a weak regulatory framework, an ineffective private sector, a low level of domestic savings and the absence of an adequate stock market diminish the ease of privatisation in these countries [Ariyo and Jerome, 1999]. Urgency, moreover, does not attract investors. Potential buyers only consider purchasing unprofitable companies if they are allowed to restructure them and to lay-off workers. Governments, at the other hand, hesitate to give carte blanche to a buyer, because asset stripping reduces the value of the company to the country and the firing of employees generates unemployment. Sometimes even profitable companies cannot be sold fast because governments do not like to sell profitable companies at low prices and the search for the highest bidder may take time.

In Eritrea the aforementioned conflicts of interest between potential buyers and the government slowed the pace of privatisation and both profitable and unprofitable companies listed for privatisation became stuck in a long-term privatisation period. The lack of privatisation success, however, made it possible to study companies during the process of privatisation. Because slow privatisation is not yet studied in depth at the level of the firm one may learn what aspects are relevant for a company during a long privatisation period in a developing country. Because both profitable and unprofitable companies were offered for sale in Eritrea, it was also possible to see whether differences between profitable and unprofitable companies during an extended period of privatisation could be found.

This article highlights the Eritrean privatisation policy and the direct privatisation results in section 2. Then it presents the companies studied and the case study approach in section 3. Section 4 compares the developments for state-owned and private enterprises as well as the development of profitability in two industries before and after the announcement of privatisation. Section 5 gives the reactions of company managers on privatisation. Section 6 concludes the paper.

2. Privatisation in Eritrea

Prior to 1975, Eritrea had a flourishing private industrial sector accounting for 40 % of the industrial output of Ethiopia [GOE, 1994, p.4]. In 1975, the Marxist government of Ethiopia adopted a command economic system and nationalised large manufacturing enterprises. During the period 1975-1991 it neglected the factories and drained their resources without giving necessary inputs to develop the industries. When in 1991 Eritrea became an independent country, the new government adopted a free market policy to resuscitate the economy.

The government of Eritrea began to sell small co-operative shops in 1992 and returned nationalised houses and other buildings to their former owners. In 1995 the Eritrean government established the National Agency for the Supervision and Privatisation of Public Enterprises (NASPPE) to reduce the number of public enterprises. The objectives of NASPPE are to privatise public enterprises and to implement appropriate management policies in order to vitalise productivity and to establish a competitive and conducive economic ambience in all public enterprises [GOE, 1995, p.4]. At the end of 1996, the NASPPE announced that 39 of the 42 publicly owned manufacturing enterprises should be privatised. Moreover, one of the formerly nationalised companies was liquidated, while two were not offered for sale because the government considered them as strategic.

The NASPPE has been using a direct sales method. Usually, companies are advertised in local as well as international newspapers such as The Economist. Enterprises are auctioned and investors bid for the companies. The NASPPE evaluates the price offered and the business plans of investors regarding investments, technology transfer and job creation and then makes its decision.

Table 1 shows the companies sold in each sector as well as the number of enterprises owned by the state in June 1999 and some of the company characteristics.

Table 1 about here

Table 1 shows the direct consequences for the sale of 18 companies until June 1999. In these companies 1,681 employees (22%) were employed, while 5.797 employees (78%) were with companies still to be privatised. The Eritrean government raised 156.2 million from the sales of the enterprises Nakfa (1 Nakfa may be equalled to 0.14 US dollar). 52.7 million Nakfa (34% of the total value) was received from the sale of Gash Cigarette Factory. The other 17 companies were sold for 103.5 million Nakfa.

Table 1 also indicates that the enterprises sold are relatively small and that relatively large manufacturing companies are still owned by the state. The metal and wood products industry and the chemical industry (soap factories) were privatising fast. Food, textiles, leather and shoe and non-metallic minerals (cement and salt factories) companies were less easily privatised. In fact, some of these companies were already offered for sale three or four times but are not sold yet. This was due to the fact that they did not attract investors or because the government did not accept the bid price and/or the business plan.

3. Data and case study approach

In order to find the effects of a long privatisation period, we used a top-down triangulation approach. First, we present the macro-economic developments before and after the announcement of privatisation in public and private companies. Because we also like to learn whether there is a difference between profitable and unprofitable companies during a protracted privatisation period we compared companies from a profitable with those from an unprofitable industry. We, however, had to distinguish the impact of the privatisation announcement from the impact of the increasing trouble with the neighbouring country of Ethiopia in the research period. Therefore we searched for a profitable industry with minor exports. That industry proved to be the beverage industry. The industry with overall company losses was the textile industry. The textile industry had been dependent on exports to Ethiopia in the past, but the main impact of Ethiopian export reductions was already visible in the annual accounts far before the textile companies were slated for privatisation. In fact the disappearance of export possibilities contributed to a large extent to the losses in the textile industry since 1993, while the fieldwork took place in the period from January 1998 till October 1998. For these reasons companies from the beverage industry were chosen as well as companies from the textile industry.

In comparison to Table 1 the fourth state-owned company from the textile industry was left out of the sample, because the auctioning of the company was in progress during the period of the fieldwork. Therefore we used three companies from the textile industry and three from the beverage industry (of which two still had to be sold while the third was a joint venture with a foreign investor). We study the development in individual companies from annual accounts and we add to this the opinions of individual managers.

In the privatisation literature opinions of individual managers are often neglected. This may be caused by the fact that managers are considered as agents of the state. If the state wants to sell a company, the incumbent managers may be irrelevant for the future of the company, because they will have a large change of being dismissed when the company is sold. Nevertheless, if privatisation takes a long period of time, the incumbent managers are relevant for the company during the bridging period. Moreover, an analysis of annual accounts gives meagre information on why profits are generated or losses occur. Finally, potential purchasers normally use future oriented business evaluations [Bennell, 1997, p. 1799] besides information from the annual accounts. But annual accounts are illuminations from the past. They are not future oriented and they do not indicate how revenue could be increased and cost reduced: it may often even be necessary to increase outlays in order to generate more sales, e.g. for marketing or for attracting highly qualified personnel. For these reasons the elicitation of management knowledge may be more informative than solely gathering information from annual accounts [Earle, Estrin and Leshchenko, 1996].

Management opinions were collected via open interviews aimed at general, financial, production and marketing managers of the six companies. The response rate was 92%. The managers interviewed were asked what efforts were done to improve company sales and to reduce costs, what constraints were encountered, what further plans they had in increasing sales or reducing costs and how the privatisation policy was influencing company operations. The interviews took place at the respondents' offices.

4. Changes in sales and profitability

The direct privatisation revenues presented in Table 1 do not present a complete picture of the financial consequences of privatisation to the government. According to Donaldson and Wagle [1995, p. 36] ‘Enterprises are living things, and deteriorate very quickly once they are "for sale". It is imperative, therefore, not only to complete divestitures as quickly as possible, but also to manage the business well in the interim. While a firm is for sale, key employees doubt the firm's commitment to them, are less motivated, are attracted to alternative employment….[and the] selling process is a distraction to management, which is tempted to leave critical matters unattended because they assume a new owner will take them in hand.’ If Donaldson and Wagle are correct, we might find negative effects of the privatisation announcement in the annual accounts of the remaining public companies in 1997 and 1998 (see Table 2).

Table 2 about here

Table 2 indicates that the indirect privatisation consequences may indeed have been large and negative. The operating profit of all Eritrean companies with more than 10 employees declined in from 1996 to 1997 from 253 million Nakfa to 163 million Nakfa. It is likely that the reduction in operating profit can be attributed to the state-owned enterprises. According to Table 2, the previously increasing trend in value added at factor costs was reversed in public companies. Their value declined from 315 million Nakfa in 1996 to 270 million Nakfa in 1997, while in the same period the value added with private companies increased from 37 million Nakfa to 103 million Nakfa.

Even if value added decreases in public companies during a slow privatisation period, it is not yet clear whether it affects profitable and unprofitable public companies in the same way. Table 3, therefore, gives additional information on the sales of the companies to be privatised in the two industries for the period 1992-1998.

Table 3 about here

From table 3 we see that in the year after the privatisation announcement the sales of all six companies studied declined. Moreover, while there was in most companies a clear upward trend until 1996, that trend reversed in 1997. In four companies the situation deteriorated even further in 1998 and in the aggregate sales in both the beverage industry and the textile industry declined during two consecutive years. The decline was however smaller in the beverage industry than in the textile industry. In comparison to the highest amount of sales in 1996 the sales in the profitable beverage industry declined with 12% in the first year after the privatisation announcement and with 2% the year thereafter. These percentages were respectively 20 and 24 for the loss generating textile industry. The latter figure suggests that the long term effect of slow privatisation may be worse in unprofitable industries, but such a conclusion does not hold if we consider company profits (see Table 4).

Table 4 about here

Table 4 shows that all beverage companies were profitable in 1996 and in 1997, while all companies in the textile industry showed a loss in the same period. In the year after the announcement of privatisation company 2 showed a small increase in profits and company 4 reduced its losses, but the profitability in the other four companies declined. Over a protracted privatisation period the textile industry losses reduced in 1998 in comparison to 1997, while the profits of the beverage industry declined further in 1998.

Though the effects are mixed among the companies and the industries for 1998, information from 1997 and 1998 suggests that both profit and loss generating industries may be affected negatively if the privatisation announcement is not followed by the relief of companies actually being sold

5. Managers on privatisation

We interviewed managers of the six firms in order to learn where the differences in profitability came from and what privatisation meant for their company. It proved that the textile industry was less profitable than the beverage industry because with the textiles there was less demand for the products, less selling experience, less flexibility, a higher cost structure and more competition. Despite the differences in profitability, managers from both industries were united in two respects with respect to privatisation. Firstly, the managers did not complain about the fact that their company was slated for privatisation. In general they supported the idea that privatisation would be good for the company and the country. Secondly, managers from both industries complained about the slow speed of privatisation. In this sense, the qualitative interviews with the managers also indicate the reasons for the negative quantitative developments in the annual accounts after the privatisation announcement. In particular, we found disengagement and a loss of future orientedness within the companies.

The disengagement with the employees and the managers due to the slow pace of privatisation was phrased by the production manager of the Asmara Wine and Liquor Factory in the following way: *"People have become disinterested due to privatisation. They say the factory will be sold. So there is no need for working hard or for future planning.... The enterprises management team used to meet monthly but now -since we heard that the company is to be privatised- we never meet".* Privatisation diminished the orientation on the future too and the marketing manager of the Asmara Wine and Liquor Factory phrased the influence of privatisation on company operations as follows: *"Privatisation does not help in future planning. Also the people do not work on full mentality and they do not have any vision at the moment because their future is not secure."*

Despite agreement upon the merits of privatisation and unity in condemning the slow pace of privatisation, there were also differences between the managers from the two types of industry. The different (profitability) backgrounds of the companies caused differences in reference frames and focus during the protracted privatisation process. For example, managers in the profitable beverage industry do see potential for direct improvements, while the managers of the textile industry only see a future for the company if it will be privatised. The general manager of the Asmara Brewery said: *"In 1995 we started a renovation project, but the NASPPE has stopped us from enacting the second phase on the ground that -if the factory is to be sold- we should leave it to the new buyer to choose any kind of investment...".* The production manager of the Eritrean Textile Factory at the other hand assumed that his company should be privatised before innovation could take place: "*We expect to privatise the company and hope that this will bring new technology*". In fact the textile industry may even expect a financial impulse from the new owner as phrased by the financial manager of the Eritrea Textile Factory "*The delay of privatisation is aggravating the financial problem of the company. ... Had there been an ownership change, the new buyer would have injected new finances...*"

Moreover, the managers in the beverage industry were more oriented to investments, while the managers of the textile industry were struggling for survival by reducing costs. This gave a different focus to their ideas about where to look for improvements. For example, the marketing manager of the Asmara Wine and Liquor Factory stated: *"We had a plan to introduce automatic machines and to improve sales but due to privatisation we do not have any plans"*, while the general manager of the Eritrea Textile Factory at the other hand said: "*If the company would be privatised, the new owner could reduce costs by self financing the company and this would enable the company to become competitive in the market*". In fact the managers of the textile industry may not even dare to think about proposing investments to the NASPPE. The general manager of the Eritrea Textile Factory, for example, said: "*If we want to invest in fixed assets, we have to present our proposal to the NASPPE. But due to the losses that we have they will not approve any new fixed asset investment*".

In the beverage industry the managers not only complained about the restrictions imposed on investing in fixed assets, but the NASPPE also restricted the amount of inventory. Companies were allowed to buy stocks needed for three months only. This guideline did not affect local purchases, but it created a problem for foreign purchases. Quite some companies had been buying stocks from foreign countries on a six months basis because it takes a very long time until deliverance. The curtailing of stock thus inconvenienced the normal operations of companies. The general manager of the Asmara Brewery for example said: *"When our factory was offered for privatisation, we were not allowed to keep a large amount of stock. This was hampering our production. The buyer is obliged to buy the stock at the time of privatisation. Therefore, in order to minimise the burden on the buyer, we were restricted to a limited period of inventory. This restriction increases our ordering costs and since our factory requires a large amount of malt, it creates a problem."*

The differences in profitability, reference frame and focus thus resulted in different complaints about the slow pace of privatisation. The managers from the beverage industry complained about the restrictions of the NASPPE, while the managers from the textile industry complained about the long duration itself. Where the general manager of the Asmara Brewery said "*Privatisation has been the main constraint in upgrading machinery. The Board of the NASPPE does not allow long-term investments in machinery*", the marketing manager of the Eritrean Textile factory said: *"To solve the problems that the company is facing, the privatisation process should be accelerated*".

6. Summary and conclusion

Privatisation in developing countries is a hot issue. It is assumed to improve the economic efficiency of the country and to reduce government expenditure on unprofitable companies. Even profitable companies may be offered for sale for the cash that it may provide to the government. However, the more a country may need privatisation, the more difficult actual privatisation may be. Eritrea is no exception. Its government openly adopted privatisation as a part of a liberalisation policy and at the end of 1996 39 companies were slated for privatisation. However, mainly small companies were sold and most large industrial companies remained under state authority. This offered the opportunity to investigate the effects of a long duration of privatisation.

The unprofitable Eritrean textile industry had problems with demand, costs, competition, experience and flexibility and the question arises whether even new management can make these companies viable. The privatising of these companies may thus be difficult. At the other hand it should not be too difficult to sell the profitable beverage companies where the aforementioned problems are much smaller or non-existent. But the profitable beverage companies were not sold either. After the privatisation announcement profitability declined in both the beverage and the textile industry. Moreover, in both industries managers complained about the slow privatisation process. Their complaints were not based on a disliking of privatisation in general, but on their interest in the growth and the survival of their company. This was frustrated, because the protracted selling period created uncertainty and disengagement and diminished the orientation to the future. In the profitable beverage industry the slow pace of privatisation frustrated growth because the privatisation authorities restricted investments. In the unprofitable textile industry managers complained that the long duration of privatisation made it impossible to get outside financing quickly.

Strictly speaking, we cannot extend our findings outside Eritrea, but we assume that the negative effects may be found in other developing countries where privatisation is difficult too. Our findings suggest that the process of privatisation itself can endanger profitability. If privatisation should relieve government budget deficits, one should not only to take into account the direct cash revenues of selling companies, but also the negative impact of a long privatisation period. This conclusion is relevant for profitable as well as for unprofitable companies. Moreover, outside investors do not only pay cash to the government. New owners may also bring additional financial resources into the company and -most relevant- they will try to improve profitability by fostering (new) authorities, trust and an orientation to the future. In order to break an inherent vicious circle, the privatising of profitable and unprofitable companies should therefore not take a long time.

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Table 1. Number and characteristics of manufacturing companies sold or still for sale in various industries in Eritrea (June 1999)

Sector	# Sold	# of employees	Sale price (mln. Nakfa)	# not sold	# of employees
Foods	1	62	5	5	849
Beverages	1	47	8.8	2	627
Tobacco& Matches	1	136	52.7	1	104
Textiles & Fibre	2	731	15.2	4	2,544
Leather & Shoe	1	121	5.4	4	964
Metal&Wood	8	365	36.4	2	109
Non-metal Mineral	-	-		3	600
Chemicals	4	219	32.7	-	-
Total	**18**	**1,681**	**156.2**	**21**	**5,797**

Source: information received on request from the NASPPE

Table 2. Operating profit of all companies and value added at factor costs in public and private companies, Eritrea, 1992-1997 (*1000 Nakfa at current prices)

Year	All companies	All companies		Public companies		Private companies	
	Operating profit	#	Value added	#	Value added	#	Value added
1992	110,733	116	158,866	44	141,681	72	17,185
1993	109,652	121	181,249	45	168,934	76	12,315
1994	106,052	131	184,766	46	163,475	85	21,291
1995	217,477	138	302,137	46	278,010	92	24,127
1996	253,438	157	352,087	46	315,212	111	36,875
1997	163,321	205	373,333	46	270,227	159	103,106

Source, State of Eritrea Ministry of Trade and Industry, *Report on Census of Manaufacturing Establishments 1992-1997*, Asmara, November 1998, p. 11, 13 and 14.

Table 3. Sales of the companies investigated in the period 1992 - 1998.

	Beverage industry company number				Textile industry company number			
	1	2	3	Total	4	5	6	Total
Year	Amounts (*1000 Nakfa)							
1992*	25,005	1,234	4,503	30,742	8,561	2,440	2,162	13,163
1993	56,719	1,772	16,606	75,097	12,226	2,502	9,290	24,018
1994	62,769	2,289	20,897	85,955	26,221	9,289	9,381	44,891
1995	125,552	3,153	24,786	153,491	37,541	6,430	6,430	50,401
1996	148,572	4,482	27,751	180,805	39,430	10,232	8,999	58,661
1997	130,764	4,355	24,680	159,799	35,651	6,862	4,322	46,835
1998	131,046	1,809	23,686	156,541	27,482	1,890	6,436	35,808

*For the 1.5 accounting year period 1991/92 we calculated the results on a yearly basis

Source: *annual accounts received on request from the companies*

(The company numbers refer to respectively: 1 = Asmara Brewery, 2 = Asmara Wine and Liquor Factory, 3 = Red See Bottlers, 4 = Asmara Textile Factory, 5 = Eritrea Textile Factory and 6 = Lalmba Sack Factory)

Table 4. Operating results of the companies investigated in the period 1992 - 1998.

	Beverage industry company number				Textile industry company number			
	1	2	3	Total	4	5	6	Total
Year	Amounts (*1000 Nakfa)							
1992*	13,703	108	1,834	15,654	773	-81	-390	302
1993	31,364	315	7,306	38,985	-5,245	-2,961	3,268	-4,938
1994	36,134	567	9,117	45,818	-9,524	-938	370	-10,092
1995	68,655	1,226	10,329	80,210	-4,943	-2,932	783	-7,092
1996	73,876	1,765	10,168	85,809	-2,354	-550	-336	-3,240
1997	56,305	1,813	7,856	65,974	-1,801	-2,597	-657	-5,055
1998	45,929	454	5,259	51,642	-4,339	-1,084	868	-4,555

*For the 1.5 accounting year period 1991/92 we calculated the results on a yearly basis

Source: *annual accounts received on request from the companies*

(The company numbers refer to respectively: 1 = Asmara Brewery, 2 = Asmara Wine and Liquor Factory, 3 = Red See Bottlers, 4 = Asmara Textile Factory, 5 = Eritrea Textile Factory and 6 = Lalmba Sack Factory)